IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1724

HARRY G. BURKS, JR., *et al.*, *Petitioners*,
v.
HOWARD M. LASKER, *et ano.*, *Respondents*.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF OF INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE IN SUPPORT OF DEFENDANTS' PETITION FOR A WRIT OF CERTIORARI

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Investment Company Institute ("ICI") files this brief, as *amicus curiae*, in support of the petitioners' prayer that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered herein on January 11, 1978.

This brief is filed with the consent of the parties herein.[1]

[1] The consent of respondents was conditioned on the filing of this brief within seven days of the petition for a writ of certiorari. The petition herein was filed on June 2, 1978.

I. INTEREST OF THE AMICUS CURIAE

ICI is the national association of open-end investment companies (mutual funds), their investment advisers and principal underwriters. ICI has 453 investment company members, with approximately seven million shareholders. Their assets are approximately $48 billion and account for over 90 percent of the total assets of the mutual fund industry. All of the mutual fund members of ICI are registered with the Securities and Exchange Commission under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 *et seq.*

ICI is concerned that, if permitted to stand, the Court of Appeals opinion will undermine the statutory role of independent, disinterested mutual fund directors; will leave the law concerning the authority and responsibilities of such directors in a state of confusion and disarray; and will result in the needless maintenance of derivative actions which the independent directors would otherwise determine, in the reasonable exercise of their discretion, not to be in the interest of the funds whose affairs they are authorized to govern. For the reasons stated *infra,* ICI respectfully submits that the decision of the Court of Appeals below was incorrect as a matter of law and, if permitted to stand, will substantially impair the proper operations of publicly held mutual funds under applicable state and federal law—to the detriment of both the industry and the investing public at large.

II. OPINIONS BELOW

The opinion of the Court of Appeals (Pet. App., p. 24a) is reported at 567 F.2d 1208. The opinions of the District Court (Pet. App., pp. 14a, 1a) are reported at 426 F. Supp. 844 and 404 F. Supp. 1172.

III. JURISDICTION

The judgment of the Court of Appeals was entered January 11, 1978. A timely petition for rehearing was denied by order entered March 9, 1978. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

IV. QUESTION PRESENTED

ICI adopts by reference the question stated by petitioners.

V. STATUTORY PROVISIONS INVOLVED

The statutes involved in this case are the Investment Company Act of 1940, 15 U.S.C. §§ 80a-35(a), 35(b) (1970), and the Delaware General Corporation Law, 8 Del. Code §§ 141(a), 141(b) (1974).

VI. STATEMENT OF THE CASE

The pertinent facts as well as a descriptive history of the proceedings to date are set forth in the petition.

To summarize briefly, this case was commenced by two shareholders in Fundamental Investors, Inc. ("Fundamental")—a Delaware corporation which is an open-end investment company (mutual fund) within the meaning of the Investment Company Act—purportedly as a derivative action on behalf of Fundamental. The complaint charged Fundamental's investment adviser, Anchor Corporation ("Anchor"), and all of the directors of Fundamental at the time in question, with violations of statutory and common law duties in connection with the decision in 1969 to make and retain an investment in commercial paper issued by Penn Central Transportation Company, on which payment was not made at maturity.

Following settlement of an earlier action initiated by Fundamental itself against the dealer selling the notes in issue—as a result of which Fundamental recovered a portion of its losses on this investment—a quorum of five disinterested directors, none of whom were directors at the time of the events complained of, undertook to consider what position Fundamental should then take regarding the derivative action. To assist in their deliberations, the disinterested directors retained as special counsel the Honorable Stanley H. Fuld, formerly Chief Judge of the State of New York.

Thereafter, based upon detailed legal and factual memoranda submitted to the Board by Judge Fuld indicating the derivative action to be without merit, and considering the disadvantageous effects of the litigation upon Fundamental (including, *inter alia,* the cost of the litigation and the disruptive effect upon the working relationship between the fund and its investment adviser) (*see* Pet. App., pp. 5a-6a), the disinterested directors decided unanimously that maintenance of the action would not be in the best interest of the shareholders. They determined, therefore, to seek dismissal of the derivative action.

Following extensive discovery on the issue of the independence of the disinterested directors, the District Court concluded that there was no evidence upon which their independence could be challenged. Accordingly, the District Court granted Fundamental's motion to dismiss:

> "If the minority directors were truly disinterested and independent the court will not substitute its judgment for that of the Board." (Pet. App., p. 11a).

On appeal, the Court of Appeals reversed. Although the independent directors' actions were duly authorized under the by-laws of the corporation and applicable Delaware law—and notwithstanding the important responsibilities expressly entrusted to mutual fund independent directors by Congress in the Investment Company Act, as amended [2]—the Court of Appeals felt that it would be "asking too much of human nature" to expect that the disinterested directors would act with the necessary objectivity in these circumstances in light of the "unique nature" of investment companies in general and their "symbiotic relationship" with their investment advisers. (Pet. App., p. 33a).

The record in this case contains no suggestion of bad faith on the part of the disinterested directors or of self-dealing on behalf of any defendant:

1. The District Court found that plaintiffs failed to adduce "*any* factual support for their conclusion that the members of the disinterested quorum acted other than independently" in reaching their determination to seek an end to the derivative action. (Pet. App., p. 19a (emphasis added)). The Court of Appeals stated that it had "no doubt that the five minority directors acted in good faith in all that they did." (Pet. App., p. 33a).[3]

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[2] *See infra* pp. 12-14.

[3] Nor do even the allegations of the complaint charge that the defendant directors and investment adviser realized any personal gain from the fund's purchase of Penn Central commercial paper; rather, the gravamen of the action is that the defendants were remiss in their responsibilities in making, or acquiescing in, the decision to purchase Penn Central paper in light of the information about the financial condition of the company which, plaintiffs charge, might have been obtained at the time of purchase if a more thorough review of the investment had taken place.

2. The record is clear that the disinterested quorum was fully advised; they were aware of the facts and acted in reliance upon the legal advice of distinguished special counsel in reaching their decision. The District Court found, and the Court of Appeals did not dispute, that

> "the minority directors were furnished with disinterested counsel who analyzed the legal consequences of each alternative available to the disinterested quorum. Moreover, the affidavit of the quorum chairman and the minutes of the special meetings indicate that the minority directors acted only after they had fully considered the options available to them." (Pet. App., p. 20a).

3. In acting as they did, in part upon Judge Fuld's opinion of the invalidity of the claims asserted in the derivative action and in part upon the substantial business considerations which further militated against maintenance of the action, the disinterested quorum clearly acted well within the parameters of "reasonableness"—assuming that the independent directors are not absolutely barred from so acting by policies which the Court of Appeals saw implicit in the Investment Company Act. The Court of Appeals did not question the "reasonableness" of the independent directors' decision. Rather, the Court of Appeals ruled as a *matter of law* that disinterested mutual fund directors lack the power to terminate a "nonfrivolous" shareholder derivative suit: that is, presumably, any litigation which on its face could withstand a motion for judgment on the pleadings. The Court of Appeals did not cite any specific statutory basis for its conclusion.

This case raises highly significant issues relating to the legal duties and responsibilities of disinterested mutual fund directors, which the Court of Appeals characterized as "an important question of first impression." (Pet. App., p. 25a).

VII. REASONS FOR GRANTING THE WRIT

A. The Decision Below Raises Significant and Recurring Problems Concerning the Authority and Responsibilities of Independent Directors of Mutual Funds Under the Investment Company Act.

The role of disinterested mutual fund directors was first established by the Investment Company Act of 1940 and legislatively reinforced and expanded by the 1970 amendments to that Act. These unaffiliated directors were viewed as "watchdogs" over the interests of the shareholders and charged under the statute with reviewing and approving contracts and matters in which the manager had an interest, such as the fund's management and underwriting contracts.[4] Congress viewed independent directors as providing "an independent check on management. . . ." H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970).

The decision below undercuts the statutory role for independent directors established by Congress and will have significant adverse effects on these directors and the operations of the funds they serve.

On an industry basis, mutual fund managers make literally tens of thousands of investment decisions each year with respect to billions of dollars of assets which are managed for the benefit of millions of shareholders. Each one of these thousands of investment decisions which, with the benefit of hindsight, was a poor deci-

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[4] *See infra* pp. 12-14.

sion gives rise to the possibility of a derivative action in which one or more disappointed shareholders may seek to recover on behalf of the fund the full amount of the loss from the investment adviser, affiliated directors and others.

The role of independent directors, who are not defendants or otherwise personally interested in the outcome of the action, has now been made unclear by the decision below. If the independent members of a mutual fund board of directors determine that the institution or maintenance of the claims set forth in a derivative action would not be in the interest of the fund—*e.g.*, because they determine the claims to be without merit or because of other proper considerations—should they refuse to approve or seek dismissal of the action in accordance with the Securities and Exchange Commission's view that it is the disinterested directors' responsibility to exercise "their business discretion in the best interests of the fund shareholders"?[5] Or, in accordance with the Court of Appeals decision below, must they sit back and refrain from acting so long as the claims asserted in the derivative action are not patently "frivolous"?

If independent directors cannot exercise their reasonable business judgment in such circumstances, the intent of Congress that disinterested mutual fund directors exercise discretion to determine what actions

[5] Brief of the Securities and Exchange Commission, *Amicus Curiae* at 28, *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 98 S. Ct. 421 (1977). The Commission's view also accords with the view of Congress that the provisions of the Investment Company Act were "not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969).

should be taken to protect the interests of all of the shareholders will be frustrated.

For the role of the independent mutual fund director to be an effective one, it is important that individuals of ability, experience and integrity agree to accept these positions. The decision below—which wrongfully withdraws from independent directors their authority to exercise their good faith business judgment in the interest of the fund and which unfairly denigrates such directors as a class by the unsupported assumption that they must be as a matter of law incapable of acting with objectivity—will hinder, not help, efforts to encourage responsible individuals to serve in this role. Rather than enhancing the operation of mutual funds in the interest of the vast majority of shareholders, the decision below will emasculate the role of the "independent watchdog" director that Congress selected as a "key" means of assuring that investment companies are in fact run for the benefit of their shareholders. *See, e.g., Tannenbaum* v. *Zeller,* 552 F.2d 402, 406 (2d Cir.), *cert. denied,* 98 S. Ct. 421 (1977).

B. The Decision Below Will Encourage and Compel the Maintenance of Litigation Which Is Not in the Best Interest of Mutual Fund Shareholders or the Mutual Fund Industry.

If independent mutual fund directors cannot exercise their reasonable business judgment to refuse to approve or seek dismissal of litigation they determine to be not in the best interest of the fund, ICI submits that significant undesirable results can and will occur:

First, costly and time-consuming litigation will be maintained involving claims which the independent directors of mutual funds—the persons most likely to

be both knowledgeable and objective—determine to be without merit or of such little merit as not to justify the expense and other burdens of ongoing litigation. Mutual fund investment advisers regularly make thousands of investment decisions, many of which result in losses and could give rise to litigation. The decision below will operate to remove an existing protection against the maintenance of unsound or questionable suits of this nature, which are unlikely to be in the interests of the funds on whose behalf they purport to be brought or their shareholders. The proliferation of such actions is neither in the public interest nor the interest of the judicial system. *See Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 742-43 (1975).

Second, to the extent that the maintenance of such derivative suits impairs the working relationship between mutual funds and their investment advisers, a derivative action on behalf of one or two shareholders may effectively frustrate the expectation of thousands of other shareholders.[6] If litigation desired by one or two shareholders is allowed to impair the relationship between a fund and its adviser without sufficient cause, the expectations of other investors who have chosen the fund on the basis of its adviser's past performance and reputation will not be realized.

[6] Here, one of the considerations of the disinterested directors was their view that "[i]f the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave . . . no practical alternative but to remove Anchor as investment adviser and to seek to retain a new investment adviser." (Pet. App., p. 5a).

Third, the uncontrolled maintenance of the sort of claims involved in this case poses the threat of severe disruption of the operations of the mutual fund industry—particularly with respect to the activities of investment advisers.

Investment advisers to mutual funds typically are entrusted with the management of large amounts of assets, in exchange for which they receive compensation which is customarily calculated on the basis of a small percentage of the fund's assets. In this case, for example, the damages sought could be 200 times as great as the investment adviser's annual fees attributable to management of the assets in question.[7] The spectre of defending lawsuits brought by dissatisfied shareholders essentially seeking to make the investment adviser the guarantor of the investments selected is likely to have an adverse, disruptive effect upon the operations of the mutual fund industry.[8]

C. The Decision Below Improperly Applies the Provisions and Policies of the Investment Company Act to Reach a Result Which Is in Conflict with the 1970 Amendments to That Act and With Controlling State Law.

The quorum of disinterested directors, acting pursuant to the by-laws of the corporation and in accord-

[7] Anchor's contract with Fundamental provided that Anchor would receive approximately .5% of the value of the assets managed as an annual fee. (Jt. App., p. 194A) ("Jt. App." refers to the Joint Appendix filed in the Court of Appeals).

[8] The issues for review in this case will not require the Court to determine whether damages could ever be recovered on this basis and, if so, in what circumstances. ICI merely points out that the *in terrorem* effect of suits seeking damages out of all proportion to an investment adviser's income, if they may be brought at the instance of a single shareholder without any meaningful prior screening, will be substantial.

ance with Delaware law, acted within the scope of their discretionary authority in this case. Directors of corporations generally need not pursue every conceivable legal claim—especially "where the right of the corporation to recover is doubtful":

> "The mere fact that a corporation has a cause of action for an injury does not always make it incumbent upon it to sue, any more than in the case of an individual. If, in the opinion of the directors or a majority of the stockholders, the interests of the company do not require it to sue, it need not do so. The matter ordinarily is within their discretion, and if they act in good faith, their refusal to sue violates no right of dissenting stockholders, so as to entitle them to maintain a suit in their own behalf." 13 *Fletcher Cyc Corp. (Perm Ed)* § 5822 (1970) (footnote omitted).

See, e.g., United Copper Securities Co. v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903); *Ash* v. *IBM*, 353 F.2d 491 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Alleghany Corp.* v. *Kirby*, 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966).

If the result below can be justified, it must be premised upon the Investment Company Act of 1940, which was enacted in part because of the special nature of the investment company industry to which the Court of Appeals referred. However, neither the statute nor its underlying policies (Section 1(b)) compel the departure from established principles indulged in by the Court of Appeals below. On the contrary, they compel precisely the opposite result.

When it amended the Investment Company Act in 1970, Congress specifically considered the problem of the influence exerted by the investment manager over the unaffiliated directors. Congress nevertheless chose to *reject* proposals for significant structural changes in investment company governance and instead adopted additional safeguards keyed to the important role of independent directors. Specific new provisions which were designed to assure their independence and strengthen the independent checks on management were adopted.[9]

For example, Congress added Section 2(a)(19) defining the term "interested person" and substituted that new broader concept for the term "affiliated person" as used in Section 10, which requires at least 40 percent of each fund's board to be disinterested persons. It also amended Section 15 of the Act governing ratification of advisory (management) and underwriting contracts by the board, to require approval "by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party. . . ." Congress also reinforced the statutory role of independent fund directors by amending Section 36. The Senate Report stated:

> "These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969).

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[9] *See, e.g.*, Part E: Strengthening Independent Checks on Investment Company Management, S. Rep. No. 91-184, 91st Cong., 1st Sess. 32-34 (1969) (discussing amendments to Sections 2(a), 10, 15 and 32(a) adding the term "interested person").

Thus, it is clear that independent directors of mutual funds were intended by Congress to have a significant measure of authority and responsibility in the exercise of their business judgment in such sensitive areas as approval of management and underwriting contracts.[10] There is no basis in the statute, express or implied, for precluding the exercise of such judgment by independent directors in the area of fund litigation, when the exercise of discretion is permitted—indeed mandated—in much more sensitive areas of greater consequence to the operations of mutual funds.

Nor, prior to the Court of Appeals decision in this case, have the courts interpreted the Investment Company Act to restrict the role of the independent directors in this fashion. To the contrary, the cases arising under the Act—in the Second Circuit itself as well as in other Circuits—make clear that the decision below severely undercuts the purposes of the statute and, in particular, the amendments passed by Congress in 1970.

Thus, in *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), the First Circuit refused to permit a shareholder derivative action on behalf of a mutual fund, where the shareholder had not initially made a demand

[10] Where Congress determined *not* to allow independent directors to exercise their business discretion in a normal fashion, it knew how to do so expressly. For example, contrary to state business corporation practices, under Section 17 of the Act a disinterested quorum of directors is not empowered to authorize or ratify certain specified insider transactions, regardless of disclosure, fairness or reasonableness. Instead, Section 17(b) provides that a proposed insider transaction must be submitted in advance to the SEC, which may grant an exemption if it determines the transaction to be fair and reasonable.

upon the independent directors. The court affirmed the primacy of the determinations of independent directors in the area of litigation, stating:

> "All disinterested directors must 'act honestly and according to their best judgment for the interests of all.' When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but, rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim,' it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' to decide on the appropriate corporate response. To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it." *Id.,* 479 F.2d at 266-67 (citations omitted).

As the *Kauffman* court explained:

> "We recognize the social desirability of bona fide, well founded minority suits. We also recognize the tremendous waste involved in suits that are not well founded." *Id.,* 479 F.2d at 267.

See also Moses v. *Burgin,* 445 F.2d 369 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971).

The decision below is also inconsistent with the Second Circuit's own determination in *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir.), *cert. denied,* 98 S. Ct. 421 (1977), which sustained the validity of the exercise of the sound business judgment of independent directors with respect to the issue of whether mutual funds need in all circumstances seek to "recapture" brokerage commissions. There, the Court of Appeals for the Second Circuit stated:

> "We have found nothing in the structure or legislative history of the Investment Company Act

> which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors." *Id.,* 552 F.2d at 417.

The court in *Tannenbaum* concluded:

> "Thus the decision to forego recapture here did not violate the fiduciary obligations of either the Fund's adviser or directors under section 36 of the Investment Company Act if the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors." *Id.,* 552 F.2d at 418-19 (footnote omitted).

See also Fogel v. *Chestnutt,* 533 F.2d 731, 750 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976).

Indeed, the fundamental premise of the Court of Appeals decision in this case has already been questioned by at least one District Court: "To the extent that *Lasker* assumes the independent directors to be captive to the will of the interested directors, this court disagrees." *Untermeyer* v. *Fidelity Daily Income Trust,* No. 76-1802, slip op. at 30 (D. Mass. May 4, 1978).

ICI respectfully submits that the conflicting decisions in *Kauffman* and *Tannenbaum,* on the one hand, and in this case, on the other, have left the standard of authority and duties of independent mutual fund

directors in a state of serious disarray, and that this conflict should be resolved by this Court before it spawns judicial error and needless litigation for years to come in regard to the important statutory questions involved.

VIII. CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment of the Court of Appeals below upon plenary briefing and argument.

Respectfully submitted,

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